

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200825007**

Release Date: 6/20/2008

Index Number: 2601.04-01, 2601.04-03,
2501.01-00, 61.00-00,
1001.00-00

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:4
PLR-109910-07
Date:
March 11, 2008

TY:

ABC Trust =

Year 1 =

Donor A =

Donor B =

Donor C =

Family Member 1 =

Family Member 2 =

Family Member 3 =

Family Member 4 =

Family Member 5 =

Family Member 6 =

Family Member 7 =

Family Member 8 =

Family Member 9 =

State 1 =

Family Trustee 1 =

Family Trustee 2 =

Family Trustee 3 =

Non-profit Corporation =

Corporation A =

Law Firm 1 =

General Trustee A =

Spouse A =

Child 1 =

Child 2	=
Child 3	=
Child 4	=
Child 5	=
Child 6	=
Spouse B	=
Child 7	=
Child 8	=
Child 9	=
Date 1	=
State 2	=
Family Trustee 1	=
Family Trustee 2	=
Family Trustee 3	=
General Trustee B	=
Year 2	=
District Court	=
Appellate Court 1	=
Appellate Court 2	=
Appellate Court 3	=
Year 4	=
Year 3	=
Date 2	=
ABC Trust 1	=
ABC Trust 2	=
Trustee E	=
X	=
Y	=
Law Firm 2	=
Date 3	=
State 1 Law	=

Dear :

This is in response to a letter dated February 7, 2007, from your authorized representative, in which you request rulings concerning the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed settlement agreement and proposed division of ABC Trust.

Facts

In Year 1, Donor A, Donor B, and Donor C created ABC Trust, an irrevocable trust. Year 1 is prior to September 25, 1985.

Article 3.01 of ABC Trust defines “issue” to mean all persons who are lineal descendants of the person whose issue are referred to except (i) persons who become descendants by legal adoption after attaining the age of 18 years and their descendants and (ii) illegitimate descendants and their descendants. Article 3.02 defines “child” to mean an issue of the first generation and “grandchild” to mean a child of a child.

Article 3.04 of ABC Trust provides that the beneficiaries of the trust are identified by classes, as follows:

- (1) Class One includes all the children of Family Member 1;
- (2) Class Two includes the spouses of all of the children of Family Member 1;
- (3) Class Three includes all of the grandchildren of Family Member 1;
- (4) Class Four includes the spouses of all of the grandchildren of Family Member 1;
- (5) Class Five includes all of the issue of the grandchildren of Family Member 1;
- (6) Class Six includes the spouses of all of the issue of the grandchildren of Family Member 1;
- (7) Class Seven includes Family Member 2 and Family Member 3;
- (8) Class Eight includes Family Member 4 and Family Member 5;
- (9) Class Nine includes the spouse of Family Member 4 and the spouse of Family Member 5;
- (10) Class 10 includes all of the children of Family Member 4 and all of the children of Family Member 5;
- (11) Class 11 includes the spouses of all of the children of Family Member 4 and the spouses of all of the children of Family Member 5;
- (12) Class 12 includes all of the issue of the children of Family Member 4 and all of the issue the children of Family Member 5 and all of the issue of the children of the donors;
- (13) Class 13 includes the spouses of all of the issue of the children of Family Member 4 and the spouses of all of the issue of the children of Family Member 5;
- (14) Class 14 includes all of the issue of Family Member 6; and
- (15) Class 15 includes all of the issue of Family Member 7.

Article 4.01 of ABC Trust provides that the power to make distributions of income and principal from the trust is vested solely in the trustees possessing the power of discretionary distributions under Article 5.01 of ABC Trust. All income not distributed will be accumulated and added to principal. Article 4.01 also provides that distributions may be made to one, some, or all members of any classes then eligible to receive distributions, in such proportions and amounts, equal or unequal, as the trustees possessing the power of discretionary distributions deem advisable, in their sole discretion. Article 4.01 further provides that the power to make distributions will include the power to make complete distribution of all the trust assets at any time and thereby terminate the trust. Persons eligible to receive distributions shall be the living members of the classes, in the order of eligibility as provided in Article 4.01(1) and 4.01(2).

Article 4.01(1) of ABC Trust generally provides that persons eligible to receive distributions are the living members of Classes One through Six, until the closing of all of Classes One through Six.

Article 4.01(2)(i) provides that the persons eligible to receive distributions after the closing of Classes One through Six are members of Classes Seven through Thirteen. Article 4.01(2)(ii) provides that after the closing of Classes Seven through Thirteen, members of Class Fourteen are eligible to receive distributions. Article 4.01(2)(iii) generally provides that after the closing of Classes Seven through Fourteen, members of Class Fifteen are eligible to receive distributions.

Article 4.02 of ABC Trust provides that in the event of the closing of all classes, the trust assets shall be distributed to such persons, other than any heir-at-law of Family Member 8, as would be determined to be the heirs-at-law of the donors' great grandmother, Family Member 9, had she died intestate immediately following the event that causes the last closing of a class under the statutes of descent of State 1.

Article 5.01 of ABC Trust provides, in part, that trustees possessing the power of discretionary distributions include those trustees acting under the trust instrument except any trustee (a) who by possessing a discretionary power to distribute or withhold any income or principal from any trust created hereunder would be a younger generation beneficiary having a present power with respect to any of the three donors, (b) who is eligible to receive distributions from any trust created hereunder or who has the legal obligation to support a beneficiary who is eligible to receive distributions from any trust created hereunder, (c) who is a member of any of Classes One through Thirteen, or (d) who, with respect to any of the donors, is a related or subordinate party" within the meaning of § 672(c) of the Internal Revenue Code.

Article 5.02 of ABC Trust provides, in part, that ABC Trust is intended to endure in perpetuity, except as otherwise required by the governing law of Trust.

Article 5.04 of ABC Trust provides, in part, that any distributions from the trust to a beneficiary may, in the sole discretion of the trustees possessing the power of discretionary distributions, be retained for the sole benefit of the beneficiary in a separate trust, referred to as a "Distribution Trust."

Article 6.01(1) of ABC Trust generally provides for the creation of three family trusteeships, designated as Family Trustee 1 trusteeship, Family Trustee 2 trusteeship, and Family Trustee 3 trusteeship. The original Family Trustees are issue of Family Member 1. Each original Family Trustee and his or her successors shall have the power to appoint his or her successor from among the issue of Family Member 1 who have attained age 21 years and are willing to serve. Article 6.01(1) further provides that if any original or successor Family Trustee ceases to serve without having appointed a successor or if an issue appointed dies prior to attaining age 21, the family trusteeship

will be filled by the oldest living issue of Family Member 1 who has attained age 21 years and is willing to hold such trusteeship. If all of the issue of Family Member 1 are deceased at any time when a vacancy occurs in a family trusteeship, the trusteeship will cease and the number of family trusteeships will be reduced.

Article 6.01(2) of ABC Trust generally provides that there shall be at least two but no more than three General Trustees who are capable of possessing the power of discretionary distributions under Article 5.01. Article 6.01(2) further provides, generally, that if any General Trustee, other than General Trustee A or any successor to General Trustee A, ceases to serve, that General Trustee will be succeeded by an individual selected by “qualified officers” of Non-profit Corporation or, in the alternative, by “qualified directors” of Corporation A. Article 6.01(2) provides that a third General Trustee may be appointed by the original General Trustees or, in the alternative, by the qualified officers of Non-profit Corporation or qualified directors of Corporation A. Article 6.01(2) also provides that in the event General Trustee A or any successor to General Trustee A ceases to serve, two partners of Law Firm 1 will designate a successor who is a partner, associate, officer, director, or member of Law Firm 1 or of any successor law firm (hereinafter a “member of Law Firm 1”). The power to designate will be exercised by two partners of Law Firm 1 as often as there is a vacancy in the trusteeship originally filled by General Trustee A so that, except as otherwise provided in Article 6.04(3) of ABC Trust, a member of Law Firm 1 will always be serving as a General Trustee.

Article 6.04 of ABC Trust provides that the trustees exercising all powers conferred by law or by this agreement will do so unanimously, except as otherwise provided in Article 6.04. Article 6.04(3) provides that a majority of all Family Trustees acting hereunder shall have the power to determine that no member of Law Firm 1 will act as trustee under the trust agreement.

Article 6.05(10) of ABC Trust provides that the trustees possessing the power of discretionary distributions will have the power to transfer the situs of the administration of the trust from State 1 to any other jurisdiction.

Article 7 of ABC Trust provides, in part, that the situs of the trust is the state in which the trustee or trustees who have physical possession of the trust assets reside. Article 7 further provides that the rules of law and statutes of the state having situs of the trust from time to time will govern in all respects, except that the law of State 1 will govern compliance with the requirements of execution of the trust agreement.

At the creation of ABC Trust, Family Member 1 was married to Spouse A and had six children: Child 1, Child 2, Child 3, Child 4, Child 5, and Child 6 (the “Older Children”). Subsequent to the creation of ABC Trust, Family Member 1 married Spouse B. Three children, namely, Child 7, Child 8, and Child 9 (the “Younger Children”), were born to Spouse B during the marriage. A final judgment of dissolution of the marriage of Family

Member 1 and Spouse B was entered on Date 1 in State 2. Prior to the dissolution of the marriage and prior to the birth of Child 9, Family Member 1 raised the issue of whether Child 7 and Child 8 were his biological children. Nevertheless, in an agreement incorporated into the final judgment of dissolution of marriage, Family Member 1 conceded that the Younger Children were children of the marriage and agreed that, with respect to any testamentary disposition, the Younger Children would share equally and no differently than Family Member 1's children from prior or future marriages.

The current trustees of ABC Trust are Family Trustee 1, Family Trustee 2, Family Trustee 3, General Trustee A and General Trustee B. General Trustee A is an original trustee and a member of Law Firm 1. General Trustee B is a member of Law Firm 1, appointed in accordance with Article 6.01(2) of ABC Trust. ABC Trust has been administered under the laws of State 1 since inception in accordance with the situs and choice of law provisions in Article 7 of ABC Trust. Presently, the classes eligible to receive discretionary distributions include Classes One through Six as described in Article 4.01 of ABC Trust. The assets of ABC Trust consist of cash, marketable securities, and equity interests in closely-held corporations, partnerships, and other business organizations. The trustees represent that there have been no actual or constructive additions to ABC Trust since September 25, 1985.

Litigation began in Year 2 when the current trustees of ABC Trust petitioned District Court in State 1 (the "Year 2 Petition") for an order determining the proper beneficiaries of ABC Trust. The trustees moved for a summary judgment declaration that only biological and legally adopted children of Family Member 1 are considered "issue" of Family Member 1. The Younger Children moved for a summary judgment declaration that Younger Children are considered potential Individual Beneficiaries of Class One. The Older Children filed documents in support of the trustees' position. District Court granted the trustees' motion for summary judgment. Appellate Court 1 reversed District Court and ordered that summary judgment be entered in favor of the Younger Children, concluding that State 1 Law did not authorize the trustees to collaterally attack the younger children's parentage previously adjudicated in State 2. The trustees' petitions for review to Appellate Court 2 and Appellate Court 3 were summarily denied.

Additional litigation followed with regard to the reimbursement of attorney fees and expenses that the Younger Children and the Older Children incurred in relation to the Year 2 Petition. In separate orders, District Court awarded both parties the reimbursement requested. After an appeal to Appellate Court 1, this litigation was concluded by Year 4.

In Year 3, the Younger Children petitioned District Court in State 1 (the "Year 3 Petition") requesting an order (a) requiring the General Trustees of ABC Trust (General Trustee A and General Trustee B) to allow counsel for the Younger Children to inspect and copy all documents relating to the administration of ABC Trust; (b) imposing personal liability on General Trustee A and General Trustee B for attorney fees and

expenses that the trustees charged against the trust assets in connection with the identity of the beneficiaries of ABC Trust; (c) imposing personal liability on General Trustee A and General Trustee B for any and all attorney fees the trustees charged against the trust assets in connection with proceedings on the Year 3 petition; (d) charging against the trust assets the reasonable attorney fees and expenses incurred by the Younger Children in proceedings on the Year 3 Petition; (e) removing General Trustee A and General Trustee B as trustees of Trust and directing that all successors to such trustees will be appointed by District Court; and (f) appointing an independent, institutional trustee as successor to General Trustee A and General Trustee B.

After the filing of the Year 3 Petition, the parties to the litigation engaged in substantial discovery and motion practice over a period of 19 months before agreeing to mediate the ongoing dispute. District Court appointed a guardian ad litem to represent the interests of the minor children of the Older Children and any other unborn or unascertained person who might claim an interest in ABC Trust by or through a relationship to the Older Children or their respective issue and appointed a second guardian ad litem to represent the interests of the potential future respective spouses, issue, and spouses of issue of the Younger Children, and any unborn or unascertained person who may claim an interest in ABC Trust by or through a relationship to the Younger Children or their respective issue. Shortly before trial was scheduled to commence on the issues included in the Year 3 Petition, the parties ultimately agreed to, and the guardians ad litem consented to, a final "Settlement Agreement and Release" (hereinafter, the "Agreement") in which ABC Trust would be divided into two trusts, one for the benefit of Older Children and one for the benefit of Younger Children, with certain modifications as provided in the incorporated trust agreements. The Agreement was approved by order of District Court on Date 2, contingent on the issuance by the Internal Revenue Service of a favorable private letter ruling with respect to the income, gift, and GST tax consequences of the proposed division and modification of ABC Trust.

Pursuant to the Agreement, ABC Trust will be divided into two trusts, ABC Trust 1 and ABC Trust 2. ABC Trust 1 will be administered by General Trustee A, General Trustee B, Family Trustee 1, Family Trustee 2, and Family Trustee 3 (the current trustees of ABC Trust) for the primary benefit of the Older Children and the other members of their respective family lines pursuant to the ABC Trust 1 trust agreement. ABC Trust 2 will be administered by Trustee E (as the original trustee) for the primary benefit of the Younger Children and the other members of their respective family lines pursuant to the ABC Trust 2 trust agreement. ABC Trust 1 will be allocated X percent of the assets and liabilities of ABC Trust and ABC Trust 2 will be allocated Y percent of the assets and liabilities of ABC Trust. All assets and liabilities will be allocated on a pro rata basis provided that (a) if necessary, the number of shares of common stock of closely-held Corporation B that are allocated to ABC Trust 1 will be rounded up to the nearest whole number and number of shares allocated to ABC Trust 2 will be rounded

down to the nearest whole number; (b) all shares or other interests in closely-held Corporation A owned by ABC Trust will be allocated to ABC Trust 1 and additional cash will be allocated from ABC Trust to ABC Trust 2 to the extent necessary to provide ABC Trust 2 with Y percent of the assets of ABC Trust; and (c) all units or interests in Association owned by ABC Trust will be allocated to ABC Trust 1 and additional cash will be allocated from ABC Trust to ABC Trust 2 to the extent necessary to provide ABC Trust 2 with Y percent of the assets of ABC Trust. In allocating assets, the trustees will allocate assets in a manner that is fairly representative of the unrealized appreciation and depreciation of the assets as of the effective date of the Agreement.

The Agreement also provides that legal and professional fees will be apportioned as follows: (1) the fees of General Trustee A and General Trustee B and the fees of any guardian ad litem appointed by District Court incurred in connection with the proceedings pertaining to the Year 3 petition will be paid from the assets of ABC Trust, prior to division; (2) the fees of the Older Children will be paid from the assets of ABC Trust 1; and (3) the fees of the Younger Children will be paid from the assets of ABC Trust 2.

Upon division of ABC Trust into ABC Trust 1 and ABC Trust 2 pursuant to the Agreement, the terms of ABC Trust 1 and ABC Trust 2 will be modified from the original terms of ABC Trust as follows:

Definitions of "Older Children," "Older Grandchildren," "Younger Children," "Younger Grandchildren," and "Family Line" are added to the trust agreements of ABC Trust 1 and ABC Trust 2. Article 3.03 of ABC Trust 1 and ABC Trust 2 provides that "Older Children" of Family Member 1 include Child 1, Child 2, Child 3, Child 4, Child 5, and Child 6. Article 3.04 of ABC Trust 1 and ABC Trust 2 provides that "Older Grandchildren" of Family Member 1 includes all of the respective children of the Older Children of Family Member 1. Article 3.05 of ABC Trust 1 and ABC Trust 2 provides that "Younger Children" of Family Member 1 include Child 7, Child 8, and Child 9. Article 3.06 of ABC Trust 1 and ABC Trust 2 provides that "Younger Grandchildren" includes all of the respective children of the Younger Children of Family Member 1. Article 3.07 of ABC Trust 1 and ABC Trust 2 provides that "Family Line" of a child of Family Member 1 includes such child of Family Member 1, the spouse of such child of Family Member 1, the issue of such child of Family Member 1 and the respective spouses of the issue of such child of Family Member 1.

The classes of beneficiaries originally described in Article 3.04(1) through 3.04(6) of ABC Trust are modified as provided in Article 3.09(1) through 3.09(6) of ABC Trust 1 and ABC Trust 2. Pursuant to Article 3.09(1) through 3.09(6) of ABC Trust 1:

- (1) Class One includes all of the Older Children of Family Member 1;
- (2) Class Two includes the spouses of all of the Older Children of Family Member 1;
- (3) Class Three includes all of the Older Grandchildren of Family Member 1;

- (4) Class Four includes the spouses of all of the Older Grandchildren of Family Member 1;
- (5) Class Five includes all of the issue of the Older Grandchildren of Family Member 1; and
- (6) Class Six includes the spouses of all of the issue of the Older Grandchildren of Family Member 1.

Pursuant to Article 3.09(1) through 3.09(6) of ABC Trust 2:

- (1) Class One includes all of the Younger Children of Family Member 1;
- (2) Class Two includes the spouses of all of the Younger Children of Family Member 1;
- (3) Class Three includes the Younger Grandchildren of Family Member 1;
- (4) Class Four includes the spouses of all of the Younger Grandchildren of Family Member 1;
- (5) Class Five includes all of the issue of the Younger Grandchildren of Family Member 1; and
- (6) Class Six includes the spouses of all of the issue of the Younger Grandchildren of Family Member 1.

A new provision is included as Article 4.02 of ABC Trust 1 and ABC Trust 2.

Article 4.02 of ABC Trust 1 provides that upon the termination of the Family Line of an Older Child, if there is then any continuing Family Line of a Younger Child, the trustees, effective as of the division date, will allocate a share of the trust to the terminated family line of an Older Child by dividing the assets of the trust into so many equal fractional shares as there are continuing Family Lines of the Older Children plus one. The share allocated to a terminated Family Line of an Older Child will be further divided into so many equal fractional shares so that there will be one share allocated to each continuing Family Line of a child of Family Member 1. Any shares of a terminated Family Line of an Older Child allocated to the continuing Family Lines of the Older Children will continue to be aggregated, held, and administered pursuant to Article 4 of ABC Trust 1. Any shares of a terminated Family Line of an Older Child allocated to the continuing Family Lines of the Younger Children will be distributed to the then acting trustee under ABC Trust 2.

With respect to ABC Trust 2, Article 4.02 of ABC Trust 2 similarly provides that upon the termination of the Family Line of a Younger Child, if there is then any continuing Family Line of an Older Child, the trustees, effective as of the division date, will allocate a share of the trust to the terminated family line of a Younger Child by dividing the assets of the trust into so many equal fractional shares as there are continuing Family Lines of the Younger Children plus one. The share allocated to a terminated Family Line of a Younger Child will be further divided into so many equal fractional shares so that there will be one share allocated to each continuing Family Line of a child of Family Member 1. Any shares of a terminated Family Line of a Younger Child allocated to the

continuing Family Lines of the Younger Children will continue to be aggregated, held, and administered pursuant to Article 4 of ABC Trust 2. Any shares of a terminated Family Line of a Younger Child allocated to the continuing Family Lines of the Older Children will be distributed to the then acting trustee under ABC Trust 1.

Article 6.01(1) of ABC Trust 1 retains the substantive provisions of Article 6.01(1) of ABC Trust except that it restricts the potential appointment of successor Family Trustees to the "Older Children of Family Member 1 or the issue of the Older Children of Family Member 1," rather than the "issue of Family Member" as provided in Article 6.01(1) of ABC Trust.

Article 6.01(1) of ABC Trust 2 retains the substantive provisions of Article 6.01(1) of ABC Trust except that Article 6.01(1) of ABC Trust 2 (a) replaces the family trusteeships of Family Trustee 1, Family Trustee 2, and Family Trustee 3 with the creation of three family trusteeships in the names of the Younger Children, which are set to begin on Date 3 and (b) restricts the potential appointment of successor Family Trustees to the "Younger Children of Family Member 1 or the issue of the Younger Children of Family Member 1," rather than the "issue of Family Member" as provided in Article 6.01(1) of ABC Trust.

Article 6.01(2) of ABC Trust 1 retains the substantive provisions of Article 6.01(2) of ABC Trust except that it removes the provision allowing the appointment of a third General Trustee.

ABC Trust 2 replaces the language of Article 6.01(2) and 6.04(3) of ABC Trust with new language in Article 6.01(2)(i) through Article 6.01(2)(iii) of ABC Trust 2. Article 6.01(2)(i) of ABC Trust 2 defines "Qualified Corporate Trustee" as a trust company or banking association with a national charter having trust powers and having at least one billion dollars under administration. Article 6.01(2)(ii) of ABC Trust 2 provides that one Qualified Corporate Trustee is required to be serving as trustee at all times. Article 6.01(2)(iii) of ABC Trust 2 provides that if no Family Trustees are acting under the agreement, then a partner, member, or shareholder of Law Firm 2 or an attorney with certain qualifications (as designated in writing by two partners, members, or shareholders of Law Firm 2) will have the power to remove or replace a Qualified Corporate Trustee and will have a duty to appoint another Qualified Corporate Trustee. At any time when one or more Family Trustees are acting under this agreement, a majority of the Family Trustees then acting will have the power to remove or replace a Qualified Corporate Trustee and will have a duty to appoint another Qualified Corporate Trustee in its place.

A new provision is included in ABC Trust 2 as Article 6.06. Article 6.06(1) of ABC Trust 2 provides that the trustee owning directly or indirectly any shares of common or preferred voting stock of Corporation B will exercise all voting rights in respect to the Corporation B shares only in accordance with the written instructions of the trustees of

ABC Trust 1. Article 6.06(2) of ABC Trust 2 provides that if any Corporation B shares are distributed or transferred to any beneficiary or other person, the trustee will first require such distributee to deliver to the trustees of ABC Trust 1 an irrevocable proxy conferring upon the trustees of ABC Trust 1 the right to exercise all voting rights in respect to such shares. Article 6.06(4) of ABC Trust 2 provides that Articles 6.06(1) and (2), including any irrevocable proxy delivered pursuant to Article 6.06(2) will be ineffective after Date 3.

Article 7 of ABC Trust 1 and ABC Trust 2 is modified from the original Article 7 of ABC Trust in that it provides that the rules of law and statutes of State 1, regardless of the state that may be the situs of the trust from time to time, will govern in all respects.

You now request the following rulings:

1. The implementation of the Agreement and the division of ABC Trust pursuant thereto will not cause ABC Trust or the resulting subtrusts to lose exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(4)(i) of the Generation-Skipping Transfer Tax Regulations.
2. The implementation of the Agreement and the division of ABC Trust pursuant thereto will not create a transfer of property that is subject to federal gift tax under § 2501 of the Internal Revenue Code.
3. No gain or loss will be recognized for purposes of § 61 or § 1001 of the Internal Revenue Code as a result of the division of ABC Trust.

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every GST, which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

Section 26.2601-1(b)(1)(i) provides that a trust qualifies for transitional rule relief from the provisions of Chapter 13 of the Code, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an

exempt trust retains exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to chapter 13 if (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the position of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

In this case, ABC Trust was irrevocable on September 25, 1985. Further, it is represented that there have been no actual or constructive additions to ABC Trust after September 25, 1985. Accordingly, ABC Trust is exempt from GST tax under § 26.2601-1(b)(1).

The terms of the Agreement, including the proposed division of ABC Trust and each of the proposed modifications to ABC Trust, are the result of a settlement of numerous issues between the Older Children, the Younger Children, and the General Trustees. The litigation between the parties has been ongoing since the Year 2 Petition, a period of over 7 years. The issues have been tenaciously litigated, including multiple appeals. Shortly before trial was scheduled to commence on the issues included in the most recent petition, the Agreement averted the need for a trial. We conclude that the Agreement constitutes a settlement of bona fide issues regarding the administration of ABC Trust and regarding the construction of the terms of ABC Trust. We also conclude that the terms of the Agreement, including the proposed division of ABC Trust and each of the proposed modifications to ABC Trust, are the product of arm's length negotiations and represent a compromise between the positions of the parties and reflect the parties' assessments of the relative strengths of their positions. We further conclude that the Agreement is within the range of reasonable outcomes under the governing instrument and the applicable law of State 1 addressing the issues resolved by the Agreement.

Accordingly, based upon the facts submitted and the representations made, we rule that the division and modification of ABC Trust, as provided, will not cause ABC Trust, ABC Trust 1, or ABC Trust 2 to lose its status as exempt from the application of the federal GST tax by reason of the effective date rule contained in § 1433(b)(2) of the Act and the application of § 26.2601-1(b)(4)(i)(B) of the Generation-Skipping Transfer Tax Regulations.

Ruling 2

Section 2501(a) provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(b) of the Gift Tax Regulations provides that, as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another, the gift is complete. But, if upon a transfer, a donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the fact in the particular case.

Section 25.2511-1(c)(1) provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-75 (9th Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

As discussed above, the Agreement represents the resolution of a bona fide controversy between the parties. The proposed settlement is a mediated settlement and is based on arm's length negotiations among all the interested parties. All interested parties who hold or may hold an interest in ABC Trust, including any minors and unborn heirs, have been represented in the negotiations that preceded the order on Date 2 approving the Agreement.

The terms of the Agreement, including the proposed division of ABC Trust and each of the proposed modifications to ABC Trust, are the result of a settlement of numerous issues between the Older Children, the Younger Children, and the Trustees. We conclude that the Agreement is reflective of the rights of the parties under the applicable law of State 1 that would be applied by the highest court of State 1. Accordingly, based on the facts submitted and representations made, we conclude that the order of District

Court on Date 2 adopting the terms of the Agreement will not cause any of the beneficiaries to have made a taxable gift for purposes of the federal gift tax under § 2501.

Ruling 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that, except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to make a non-pro rata distribution of property in kind. The distribution was a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under § 1001.

The law of State 1 authorizes a trustee on distribution of trust property or the division or termination of a trust, to make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the Supreme Court concluded that an exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements “different in kind or extent” or if the properties confer “different rights and powers.” Id. at 565. In Cottage

Savings, the Court held that mortgage loans made by different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. at 566. In defining what constitutes a “material difference” for purposes of § 1001(a), the Court stated that properties are “different” in the sense that is “material” to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65.

The practical effect of the Agreement is to sever the respective interests of the Older Children and the Younger Children. The respective interests of the Older Children and the Younger Children (and their respective family lines) in ABC Trust are entirely discretionary; no beneficiary has an entitlement to the distribution of any particular income or assets from ABC Trust at any time. The trust division and distribution pursuant to the Agreement is equivalent to and consistent with a division and distribution made by the trustees pursuant to their power of discretionary distributions under the governing instrument and is within the applicable law of State 1. Upon division and distribution, neither the Older Children nor the Younger Children (nor their respective family lines) will acquire any new or additional interests.

In the present case, the Older Children and the Younger Children are severing their respective interests under ABC Trust. However, because the trust agreement of ABC Trust and the law of State 1 authorize non-pro rata divisions, the proposed trust division of ABC Trust into ABC Trust 1 and ABC Trust 2 will not result in the Older Children or the Younger Children acquiring any new or additional interests. Therefore, under Rev. Rul. 56-347, the division of ABC Trust is not a sale or other disposition of property and does not result in a material difference in the legal entitlements enjoyed by the beneficiaries under Cottage Savings. Accordingly, no gain or loss is recognized on the division of ABC Trust for purposes of § 1001.

In addition, the present case is distinguishable from Rev. Rul. 69-486. Unlike the disguised transaction situation presented in the revenue ruling, here the trust agreement and the law of State 1 authorizes non-pro rata divisions. Accordingly, the proposed division will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original trust.

We rule that the proposed division of ABC Trust will not constitute a taxable disposition under § 1001.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

James F. Hogan
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

cc: